SUPREME COURT, U. S.
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MICHAEL RODAK, JR.

IN THE

# Supreme Court of the United States

OCTOBER TERM 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,

*Petitioner,*

v.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

## BRIEF *AMICUS CURIAE* OF CITIES SERVICE COMPANY

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## BRIEF *AMICUS CURIAE* OF CITIES SERVICE COMPANY

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### Statement of Interest of the *Amicus Curiae*[1]

Cities Service Company, *Amicus Curiae* herein by consent of the parties, is a corporation validly organized and incorporated under the laws of the State of Delaware with its principal office in New York, New York. In May, 1947, pursuant to an order by the Securities and Exchange Commission which was acting under the authority of the Public Utility Holding Company Act of 1935, Amicus exchanged its three percent, sinking fund, thirty year debenture bonds in the principal amount of $115,246,950 for its outstanding cumulative preferred and preference stocks

[1] Both Petitioner and Respondent have consented to the filing of this Brief. Their letters of consent have been filed with the Clerk.

having an aggregate par value of $58,690,000 and for which it had received on issuance $45,323,846.

In 1967, Amicus instituted an action for refund of Federal income taxes for 1953 and 1954 on the grounds that the debentures were issued at a discount which should be amortized annually, or that Amicus was entitled to a deduction for loss on retirement of the debentures due to the discrepancy between the principal amount of the debentures and their issue price. On June 11, 1973, the United States District Court for the Southern District of New York held that the "issue price" of such debentures for purposes of determining the application of Treasury Regulations 118, Section 39.22(a)-17 of the Internal Revenue Code of 1939 (Treasury Regulations Section 1.61-12; Section 1232(b)(1), Internal Revenue Code of 1954) was the fair market value of the preferred and preference shares at the time of the exchange. The Court found such issue price to be $86,313,600. *Cities Service Co.* v. *United States,* 362 F.Supp. 830 (S.D.N.Y. 1973).

Amicus, Cities Service Company, believes that the question of the issue price of bonds issued by a corporation is entirely one of fact peculiar to each issuance, but Amicus is concerned that the petitioner herein has brought the question before this Court in such manner as to induce the Court to go beyond the case before it and rule that, as a matter of *law,* the "issue price" cannot be less than the principal amount of the bonds issued unless the bonds are issued in exchange for an immediate cash payment in an amount less than such principal amount, or rule that regardless of the issue price, there can be no discount at any time unless such cash is exchanged. Such a ruling would be unwarranted in view of the Treasury Regulations and Sections 163 and 165 of the Internal Revenue Code and would be directly contrary to long established case law and the recent expression of Congress contained

in Section 1232(b) of the Internal Revenue Code as amended by Section 413 of the Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 487, which was considered a clarification of existing case law when passed by the Congress. See, Senate Report No. 91-552, 91st Cong. 1st Sess. p. 148, 1969-3 Cum. Bull. 423, 516; House Report No. 91-413 (part 1) 91st Cong. 1st Sess. p. 109, 1969-3 Cum. Bull. 200, 268. It should be noted that in 1969 Congress was primarily concerned with the inclusion of the discount in the income of the recipient bondholder.

Amicus also believes that the petitioner, although alleging that a conflict exists between the decision of the United States Court of Appeals for the Tenth Circuit in this case and the decisions of the United States Court of Claims, which petitioner deems to be correct, i.e., *Erie Lackawanna Railroad Company* v. *United States,* 422 F.2d 425 (Ct. Cl. 1970); *Missouri Pacific Railroad Company* v. *United States,* 427 F.2d 727 (Ct. Cl. 1970), modified 433 F.2d 1324 (Ct. Cl. 1970), *certiorari* denied 402 U.S. 944; and *St. Louis-San Francisco Railway Co.* v. *United States,* 444 F.2d 1103 (Ct. Cl. 1971), *certiorari* denied, 404 U.S. 1017, is seeking to induce this Court to go far beyond the question in the instant case and declare a new rule of law which would invalidate, *in futuro,* the statements by the Tax Court and the Court of Claims as to the proper method by which the issue price of bonds is to be determined when the immediate exchange is not entirely of cash for the bonds, even though such method is not before this Court and has not yet been directly ruled upon by any court and even though the instant case neither warrants nor requires such extreme rule. Amicus believes that such a declaration would be outside the scope of the instant case, would be contrary to statutory and case law, would constitute, in effect, the issuance of a declaratory judgment on a tax question, and would deprive other taxpayers of an opportunity to present their cases on their

merits and to be judged on the basis of the facts peculiar to their particular cases.

## Question Presented

What is the "issue price" of bonds which are exchanged for a consideration other than immediate cash payment?

## Summary of Argument

I. The petitioner in this case, the Commissioner of Internal Revenue, has misconstrued the entire concept of bond discount, especially as provided for in the Treasury Regulations.

Bond discount is not some mysterious, esoteric concept which depends for its existence upon the configuration of certain subjective criteria at some particular time or place. Bond discount is merely the difference between the principal amount of a bond and its issue price, and such "issue price" is, as a matter of fact, only the amount in money or money's worth received for it.

Arguments and contentions regarding the nature of the transaction in which the bond was issued, the time of the issuance, the character of the consideration received for the bond, the time of the receipt of the consideration, or whether or not the consideration is "new money", are not germane or material to the question of issue price, which is simply one of value or valuation. Characterizing or denominating the exchange as a "recapitalization" or a "reshuffling of a capital structure" or questioning whether or not the consideration received constitutes property obscures and thereby avoids scrutiny of the real question in such cases, which is simply the *value received* for the bonds.

II. The petitioner in this case is asking the Court to decide more questions and broader questions of fact and of law than are necessary to resolve the issue presented in this case.

In effect, the petitioner is asking the Court to decide issues not yet directly presented to the courts and thereby deprive the taxpayers concerned of an opportunity to properly present their cases and have them adequately considered by the courts. Adoption of petitioner's contentions would have the effect of the issuance of a declaratory judgment which is prohibited in tax cases.

## ARGUMENT

### A. *The issue price of a bond is the dollar value of the consideration received for it.*

There is nothing esoteric about the nature of bond discount. It is merely the difference in money value between what is received for bonds and the amount which must be repaid by the obligor upon maturity of the debt. The consideration may be money or property or both, but the nature of the consideration is irrelevant. It is not the nature of the consideration or the timing of the exchange which determines bond discount; it is the *value* of the consideration which governs.

Value is indisputably a question of the peculiar facts and circumstances of each debt issued by each debtor. If a corporation issues a bond receiving in exchange less value than it will be obligated to repay at the maturity of the obligation, it suffers, or will suffer, an economic loss, which if incurred in a trade or business should be deductible for income tax purposes. The Treasury Regulations have so provided since 1918. Whether the deduction is to be amortized over the lives of the bonds or deducted upon

their retirement are questions only of timing—they do not go to the nature or existence of the economic loss or discount. Petitioner would determine the *existence* of discount by reference to the timing of its deduction. This is error.

To this end petitioner argues that original issue discount pertains only to the time cash money was originally received by the issuing corporation and not to the issuance of the bonds themselves. This clearly illustrates an erroneous preoccupation with the ***nature*** and ***timing*** of the consideration received for the bonds as indicative of discount and not the *value* of such consideration. Thus in his brief (p. 13) the Commissioner contends that "in order for bond discount to arise, there must be an obligation to make an outlay, in excess of the original capital borrowed". For purposes of this part of his argument he would treat the preferred stock acquired in exchange for the bonds as if it was indebtedness when issued and the later exchange of bonds merely a payer transaction having no independent significance. Then referring to other situations where there was no such obligation to repay and where discount *did not*, in fact, occur, he erroneously concludes therefrom that discount *cannot* ever occur even in situations where the obligation is to repay an amount much greater than that borrowed. For example, on page 14 of his brief one of the conclusions drawn is that bond discount cannot arise where one security is substituted for another, because the substitution constitutes a capital readjustment in which the issuer incurred no obligation to pay anything *"in excess of the amount borrowed because of the substitution of securities"* (emphasis supplied). Nowhere is the "amount borrowed" defined, yet based upon this analysis, petitioner requests a ruling that bond discount can ***never*** arise in a "capital readjustment". Presumably, petitioner would argue that the amount borrowed is always the amount to be repaid at maturity regardless of the facts. To him the actual "amount

borrowed" is not material or pertinent. The Treasury Regulations do not agree with this concept! Under this theory bond discount would never exist where one bond is issued in exchange for another even though a considerable discount was incurred when the original bonds were issued. Presumably, any such discount would be snuffed out by the later exchange in which the original bonds are replaced by the new bonds. Neither the landmark decisions of this Court nor the decisions of any lower courts support such a contention. See *Great Western Power Co.* v. *Commissioner*, 297 U.S. 543 (1936); *Missouri Pacific Railroad Co.* v. *United States*, 433 F.2d 1324 (Ct.Cl. 1970), modifying 427 F.2d 727 (Ct.Cl. 1970). It should be noted that in the *Missouri Pacific* case the Court of Claims upon reconsideration did *not* recede from its holding that bond discount could arise upon the exchange of new bonds for old bonds.

**B.** ***A recapitalization does not preclude the occurrence or deductibility of bond discount.***

Petitioner argues that the exchange of bonds for an existing issue of preferred stock cannot result in deductible bond discount for two reasons:

(1) the transaction is a recapitalization, and

(2) the recapitalization does not result in an obligation to pay more than the amount borrowed.

Amicus submits that it is not the law that a mere recapitalization itself precludes the existence of deductible bond discount. The cases are to the contrary. See, *American Smelting & Refining Co.* v. *United States*, 130 F.2d 883 (C.A.3rd 1942); *Industrial Development Corporation* v. *United States*, 51 A.F.T.R. 1514 (N.D. Ill. 1956); *Erie Lackawanna Railroad Co.* v. *United States, supra; Cities Service Company* v. *United States*, 316 F.Supp. 61 (S.D.N.Y. 1970); *Missouri Pacific Railroad Co.* v. *United States*, 433

F.2d 1324 (Ct.Cl. 1970); *Atchison, Topeka & Santa Fe Railroad Co.* v. *United States,* 443 F.2d 147 (C.A.10th 1971); *St. Louis-San Francisco Railway Co.* v. *United States, supra; Gulf Mobile and Ohio Railroad Co.* v. *United States,* 339 F.Supp. 489 (S.D.Ala. 1972). The real question is always the issue price of the bonds. If in a recapitalization the issue price is less than the amount to be repaid at maturity, deductible bond discount arises. The only possible exceptions would be tax-free transfers, exchanges or reorganizations under Sections 351 and 368 of the Internal Revenue Code, and then only if the bonds are exchanged for other bonds in equal principal amounts so that the exchange is entirely tax-free to the security holders and to the corporation. To contend that this is not so is fallacious. See Section 354, Internal Revenue Code.

Petitioner would make no distinction between preferred stock and bonds, on the grounds that they represent the same obligation of the corporation and the bonds are really a continuation of the preferred. Of course this is not true regardless of their alleged "highly equivalent characteristics". One is equity, the other is debt; and while they may appear to have an "arithmetical equivalence" insofar as a third party is concerned, to the issuing corporation and to investors they are radically different.

This argument regarding characteristics can very readily be applied in reverse. It would be just as logical to compare characteristics and to hold the preferred stock to have been bonds instead of holding the bonds to be in reality preferred stock (as petitioner suggests). In such case the deduction would clearly be appropriate. See, *Roberts & Porter, Inc.* v. *Commissioner,* 307 F.2d 745 (C.A. 7th 1962); *Missouri Pacific Railroad Co.* v. *United States,* 433 F.2d 1324 (Ct.Cl 1970). In fact, petitioner inconsistently argues at page 13 of his Brief that the preferred stock should be

treated as if it was debt when issued. It should also be noted parenthetically that while petitioner argues strongly that such "arithmetical equivalence" precludes the existence of bond discount stemming from a recapitalization, he chides the Tax Court and the Court of Claims for implying approval of a similar alleged "arithmetical equivalence" test as the proper method for ascertaining the existence of bond discount.

Nor does the asserted similarity of terms between the preferred stock and the debentures illustrate, as petitioner argues, a "fundamental legal principle". Their distinctiveness is decisive—one is equity, the other is debt. The cases and rulings cited by petitioner in support of his alleged "fundamental legal principle" contain one determinative factor not present in the case at bar and not in many similar cases, which makes the citations and the principle inappropriate—that factor is the issuance of common stock with the bonds or the issuance of the bonds to common stockholders who remain common stockholders. It is indisputable that if bonds and common stock are issued in exchange for securities, there can be no "issue price" for the bonds which is *less* than their principal amount, because any discrepancy in value or price must be deemed to be consideration for the common stock. The Treasury Regulations recognize this. Regulations, Section 1.1232-3(b)(2); Revenue Ruling 59-387, 1959-2 Cum.Bull. 56. Likewise, if bonds are issued as dividends to the common stockholders, no *exchange* takes place and there is no "issue price". But these situations and those in the cases cited by petitioner do not exist in the instant case. The failure of bond discount to arise in *some* instances does not preclude it from *ever* arising in *any* circumstance. See *Liquid Carbonic Corp.* v. *Commissioner*, 34 B.T.A. 1191 (1936), where stock was substituted for bonds.

In discussing the case of *Claussen's Inc.* v. *United States,* 469 F.2d 340 (C.A. 5th 1972), the petitioner admits that there the bonds were distributed to common stockholders, but seeks to distinguish this decisive difference by contending that the "critical fact" common to the instant case *and* to *Claussen's* is that the issuance of the debentures was not accompanied by the acquisition of any new capital (Petitioner's Brief, p. 17, footnote 16). This is not a true or legal distinction! In the case of *Great Western Power Co.* v. *Commissioner, supra,* this Court held to the contrary. The "recapitalization" there, which did not involve the acquisition of "new capital", did not preclude the existence of discount! There is no authority or reason for the proposition that discount cannot arise unless "new" cash capital has been acquired in the exchange. It would only be true in the circumstance where the bonds are distributed as a dividend to common stockholders, but it is absolutely untrue where the bonds are exchanged for other securities and the recipients thereof retain no continuing equity interest in the enterprise. In the latter circumstance, the former stockholder becomes a creditor, who eventually must be repaid the principal amount of the bond. See, *LeTulle* v. *Scofield* 308 U.S. 415 (1940).

Nor is it permissible to analogize the situation to one where the corporation instead of issuing bonds in exchange for the preferred stock retires or redeems the preferred with cash. In such case says petitioner, no tax deduction such as for bond discount may be claimed. The analogy is fallacious for these reasons:

(1) it assumes that the stock could be retired for a cash payment equal to the principal amount of the bonds that might be issued for the same purpose;

(2) it assumes that the corporation is financially able and willing to pay cash for the entire issue of stock, but instead chose to issue bonds, and

(3) it assumes a transaction that never occurred.

Inasmuch as in the case at bar the fair market value of the preferred stock was substantially lower than the principal amount of the bonds exchanged therefor, if the stock had been retired by a cash purchase in a market transaction it undoubtedly would have cost the corporation substantially less. Additionally, there is nothing apparent in the record to show that the corporation *could* have retired the stock for cash but instead chose to issue bonds in exchange therefor.

And finally, it should be noted that it is petitioner's own contention that transactions must be given their tax effect in accordance with what actually occurred rather than in accordance with what might have occurred. *Gregory* v. *Helvering*, 293 U.S. 465 (1935). Thus if petitioner is allowed to analogize the exchange of bonds for preferred stock to the *redemption* of the stock for cash, then respondent should be allowed to analogize the transaction to the sale of bonds at a discount for cash and the use of the cash to *purchase* the shares. See, Petitioner's Brief, pp. 26-28; *Television Industries, Inc.* v. *Commissioner*, 284 F.2d 322, 325 (C.A. 2nd 1960); *Commissioner* v. *Danielson*, 378 F.2d 771 (C.A. 3rd 1967). It is the transaction actually accomplished that the Court has to pass upon, not what might have been transacted, especially when the imputed or hypothetical transaction would have been radically different than what happened. This rule should apply to both parties. Petitioner should not be heard to complain of the same analogy which it seeks to apply; but if such analogy be invalid it is just as invalid as applied to petitioner as when applied by taxpayer.

**C. *Whether bonds are issued for property or cash, or whether stock certificates are property, is irrelevant to the question of bond discount.***

Petitioner in his brief argues that a corporation's retirement of its own stock is not the acquisition of property which would give rise to bond discount, especially when the stock is cancelled upon its acquisition. Amicus submits that regardless of the merits of the argument (which petitioner admits was settled by the Congress in favor of taxpayers for years subsequent to 1969 by the Tax Reform Act of 1969) it is not relevant to the resolution of the question before the Court. As previously pointed out herein, the only question here is the "issue price" of the bonds. Whether they were issued for cash or property concerns the issue price only insofar as it entails a need for *valuation* where property is involved in the exchange. The confusion and alleged conflict in the court decisions in the past as to the existence of discount when bonds were issued for property was due primarily to the Commissioner's persistent, but erroneous, contention that discount could not arise where property was involved. See, *Nassau Lens Co. Inc.* v. *Commissioner,* 308 F.2d 39 (C.A. 2nd 1962); *Montana Power Co.* v. *United States,* 232 F.2d 541 (C.A. 3rd 1956). The original controversy has been resolved by the Congress but petitioner clings to the same old discredited concepts.

Faced with the rule annunciated repeatedly by the courts that discount may arise when bonds are exchanged for property, the Commissioner rebuts with the contention that preferred stock is not property. It should be observed that whatever the merits of the contention, it seems to be self-defeating for petitioner to contend that the acquisition of the preferred stock in exchange for the debentures did not constitute the acquisition of any property

or assets. If this argument is correct, unless there was a *gratis* distribution the issue price of the bonds under the applicable Treasury Regulations would be zero, and the entire principal amount must be amortized. Accordingly, the decision of the Court below that the fair market value of the preferred stock, i.e. $33 per share, constitutes the issue price of the bonds is clearly equitable and fair.

The truth is that the bonds were issued in *exchange* for the preferred stock and not as a distribution. It is contrary to the facts to allege, as does petitioner, that the corporation neither received nor realized anything upon the exchange. The preferred shares had value by reason of what they represented, not by reason of the certificates themselves. The corporation thus obtained the continued use of borrowed capital, which must be repaid in cash upon maturity of the bonds. It is specious and misleading to argue that the corporation receives nothing because the preferred share certificates are "not assets but only convenient machinery for evidencing shareholder interests" (Petitioner's Brief, p. 24). Obviously when the preferred certificates *evidencing* the shareholder interests are acquired the corporation retains the capital underlying the shares but upon the terms and conditions specified in the bonds. The terms of the acquisition are what is important. If it acquires such interest as a loan (which must be repaid), discount may arise. And fair market value is a reasonable measure of the amount of capital underlying the preferred shares which is borrowed when such shares are exchanged for the bonds.

The fallacy of the Commissioner's contention may be illustrated by assuming that the preferred shares were acquired by the corporation for a cash payment which, in turn, was reloaned to the corporation with the bond merely evidencing the indebtedness in a principal amount in excess

of the amount of cash borrowed. Clearly there would have been discount in such circumstances. The transaction which took place is no different in substance. A debt obligation was issued which must eventually be paid regardless of how much alleged "reshuffling" took place. To denominate a transaction as a "reshuffling" does not deprive it of its inherent economic significance and character. It is contrary to fact and patently erroneous to assume, as does petitioner, that the bonds were issued in a principal amount equal to the cash it might or would otherwise have paid to acquire the preferred stock (Petitioner's Brief, p. 32).

It is equally specious to contend that the substitution of one type of security (bonds) for another (stock) has no effect on the corporation other than a "reshuffling of a capital structure". It has the effect, as in the instant case, of obligating the corporation to repay borrowed capital that, until the exchange, it could have retained indefinitely.

Likewise, contrary to petitioner's implication, there is no dishonor accompanying the allowance of a tax deduction for interest where, theretofore, preferred dividend payments were not deductible. The obvious reason is that the corporation's obligations are not the same under each instrument—one is equity, the other is debt.

**D.** ***The court should not rule on the validity of matters or issues not before it.***

In reaching its decision in the instant case the Tax Court reviewed the law, adopted the criterion espoused by the Court of Claims for resolving the question, and held that taxpayer is not entitled to a deduction for debt discount. The criterion or theory espoused by the Court of Claims was that when a corporation acquires its own securities in exchange for its bonds, the issue price of the bonds is determined by reference to the amount orignally paid in to the

corporation for the old securities, with the immediate exchange being a mere paper transaction which finally resolves or consummates in the last issuance of debt. Petitioner, Commissioner of Internal Revenue, is applying such reasoning here in order to refute the respondent's discount deduction claim and is basing his arguments as to the exchange being a "recapitalization", "reshuffling", "substitution", etc. . . . squarely on the Court of Claims rationale and that of the Tax Court in this case. See, *Union Pacific Railroad Company* v. *United States,* 401 F.2d 778 (Ct.Cl. 1968); *Erie Lackawanna Railroad* v. *United States, supra; Missouri Pacific Railroad* v. *United States,* 427 F.2d 727 (Ct.Cl. 1970); *National Alfalfa Dehydrating and Milling Co.* v. *Commissioner,* 57 T.C. 46 (1971). See also, Petitioner's Brief, p. 28, footnote 26. Yet, at the same time that he is asking this Court to hold that no debt discount arose because of the application by the Tax Court of the proper criterion, he is asking it to turn around and reject the theory upon which such holding would be based, i.e., issue price must be determined by reference to the amount originally paid for the stock. Amicus submits that the "original consideration" theory, for which petitioner ultimately seeks rejection-in-advance, is not before the Court and its validity should be ruled upon only when properly and adequately presented in context. It should not be resolved without full consideration of all of the facts and circumstances. In substance, petitioner is seeking a declaratory judgment as to tax matters, which is prohibited by law. See, 28 U.S.C. Section 2201. Petitioner also seeks to induce the Court to decide other cases not now before it by referencing the facts in such cases as though they were matters of law. This it should not be allowed to do.

## CONCLUSION

For the foregoing reasons the judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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